RICHARD RUSSELL'S DOW THEORY LETTERS INCORPORATED

PO Box 1759, La Jolla, California 92038 — SINCE 1958 — 17 Letters Per Year - $250 Annually

LETTER 1326

October 31, 2001

October 12, DJIA 9346.16; PTI 5311; A-D Ratio -3.48
October 19, DJIA 9204.11; PTI 5311; A-D Ratio -3.75
October 26, DJIA 9545.17; PTI 5309; A-D Ratio -3.19
Dow yield: 1.88% Dow p/e: 27.58
Gold 50-day MA: 283

FEATURE CHART: Below you see a monthly chart of the S&P 500. I interpret this chart as the picture of a giant top in progress. Markets often, mysteriously, produce very symmetrical formations. This formation has the look of almost perfect symmetry.

What we see here is a huge potential "head-and-shoulders top." The left shoulder required roughly a year to form. If the right shoulder takes anywhere near that long to complete (and I think we're on the right shoulder now) the formation would not be completed until next year.

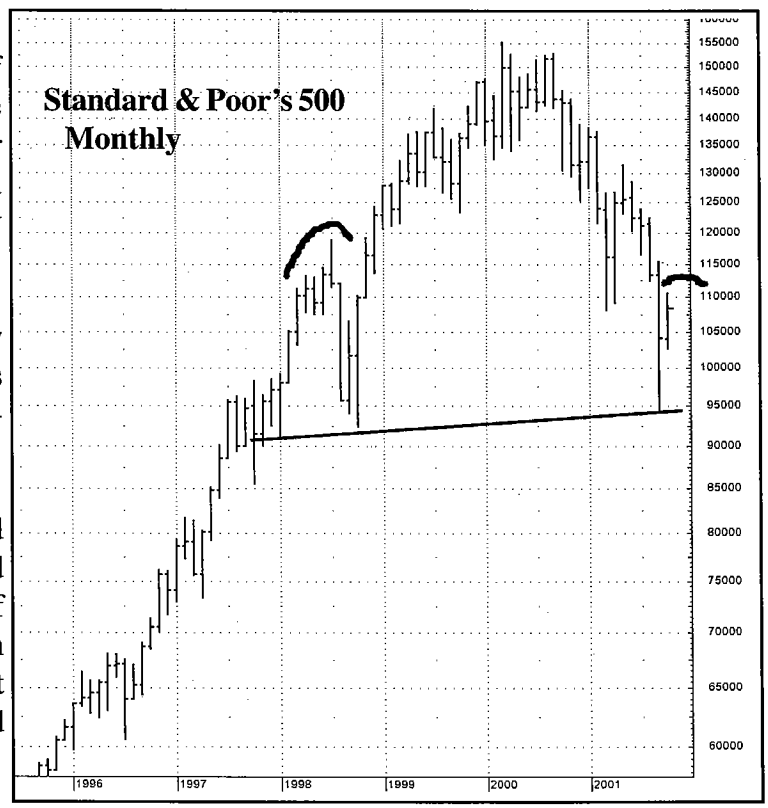
However, in weak situations the right shoulder of a head-and-shoulders top will often be abbreviated. If that's to be the case, then obviously I would expect this head-and-shoulders top-pattern to break down much earlier.

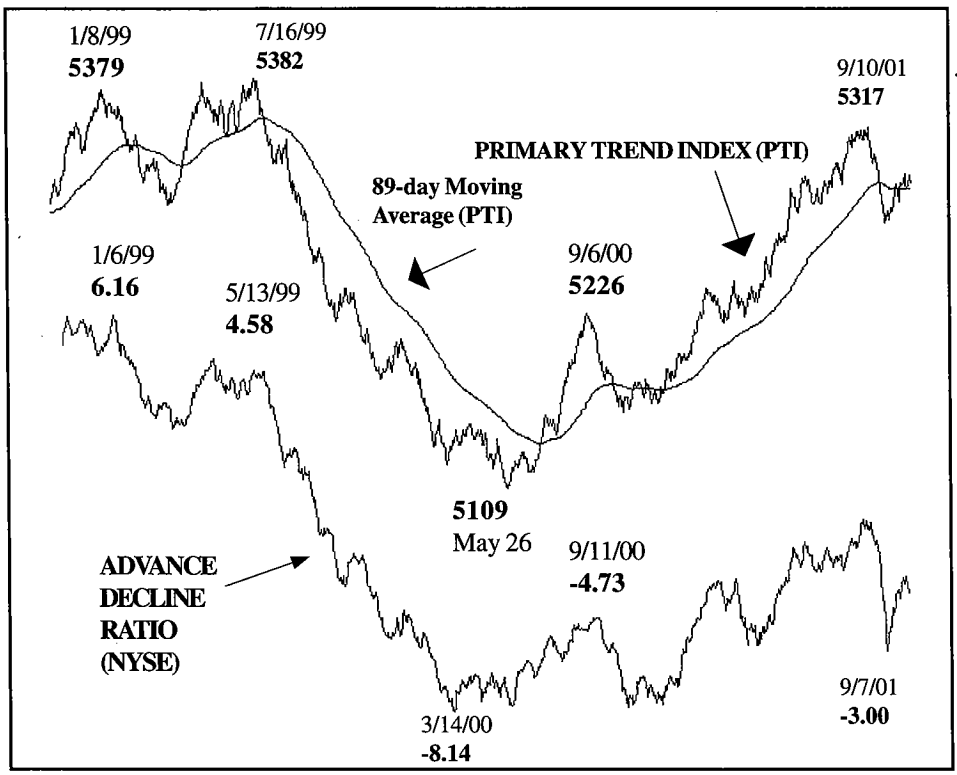
THE PICTURE: I've been reviewing the writings of my mentor, the great E. George Schaefer. He was the Dow Theorist who called the exact bottom of the bear market in June of 1949. And he called the top of the bull market in 1966. Schaefer revolutionized Dow Theory by adding a number of studies to basic Dow Theory.

But Schaefer also went back to the roots of the Dow Theory, and by that I'm referring to the work of Charles H. Dow and William Hamilton. Let's listen to a few comments by Schaefer written on March 8, 1952.

"The market philosophy of Charles H. Dow is based upon values, economic conditions, mass psychology and the pattern of the averages. Don't make the mistake of looking only at the pattern of the averages. Their pattern is a result, not a cause, of three much more important factors that go before – values, economic conditions and mass psychology.

"Each week I receive letters from Dow Theorists who are worried about the averages breaking this or that point, and telling me why a bear market could be indicated thereby. This type of reasoning has been wrong all the way up in this bull market. Look at it this way. If you were to determine the direction of the ocean's tide, you wouldn't go out and measure each little wave or ripple, would you? No, you would understand and realize that nature's forces govern the tide, and nothing else. So it is with the stock market.





"Both Dow and Hamilton based their analyses and predictions upon fundamental conditions such as values, investment buying, and the psychology of the masses, and not upon the pattern of the averages. During the past year certain so-called Dow Theorists have placed an undue and unwarranted emphasis upon what the averages did, with the result that every Tom, Dick and Harry watches the averages and thinks he is following the Dow Theory. Nothing could be further from the truth.

"The average person doesn't even know that both Dow and Hamilton (the men who originated the Dow Theory, and who should know most about it) seldom ever mentioned the averages. Their analysis went much deeper than that. Dow put his greatest weight upon values, and the buying of values by important investment sources. Hamilton added mass psychology to his method of analysis under Dow Theory.

"To get the best investment results from Dow Theory, one must become a student of Dow's three trends. It is important to differentiate between the three trends, to understand how the minor and intermediate trends can fool you — and to disregard them, and to learn the direction of, and the conditions, which reveal when the major or primary trend is turning.

"As a rule, primary bull trends have lasted from 4 to 8 years in market history, and primary bear trends have generally lasted 3 to 5 years. To be fully invested in dividend-paying growth situations all the way up when the primary trend is bullish, and to sell out at the top, remain in cash at the beginning of a major bear market, are the objectives and final accomplishments we strive and study for under correct Dow Theory procedure."

I want to stress two items gleaned from the above. The first is the buying of undervalued stocks and the selling of overvalued stocks. The second item I want to stress is the overriding importance of the primary trend and the danger of being deceived by the minor and secondary movements.

So it all comes down to this – stocks travel in major and extended trends. This is the surest and most important single fact to know about stocks. In major bull trends stocks continue to climb until they reach what Dow Theorists call the overvalued zone. This is where stocks sell for high price/earnings ratios and pay sub-standard dividends. Classically, when the Dow has paid dividends of 3% or less, stocks were considered overvalued.

In bear markets, stocks decline to the point where they are undervalued or are selling "below known values." Here, classically, we've seen the Dow sell well below 10 times earnings while yielding 6% or even more.

This sounds simple — just buy 'em when they're cheap and sell 'em when they're expensive. Unfortunately, it's not that easy. It's not easy because we have to deal with all those deceptive minor and secondary movements. And we have to listen to all that deceptive market talk from strategists and brokers and know-nothing talking heads who tend to mess up our thinking.

Remember, 90% of all decisions in the market (and probably elsewhere) are made for **emotional reasons**. In the market your emotions are almost always calculated to steer you wrong. The antidote to emotions in the market is knowledge, experience and reasoning.

As I see it, this bear market (unfortunately) promises to be a long and extended affair. One main reason why I believe it will be long is an item that I talked about many months ago – the Fed will fight any downturn "tooth and nail." Instead of allowing the natural forces of correction to take place, the Fed will move to manipulate the bear market.

Will it work? Can the Fed reverse the great primary trend of the market? I doubt it. The primary trend is the most powerful of all economic forces. I doubt sincerely whether the Fed or most people today even believe there is such a thing as the primary trend of the market. But believe me, there is.

I guess the most astounding phenomenon in economics is that today's so-called strategists and experts deny the truth that Dow uncovered over a hundred years ago. There is a primary bull trend and there is a primary bear trend. These trends will run to completion regardless of any and all manipulation. These trends can be held back, but holding them back serves only one purpose – it extends the trends. Which is probably why bull and bear markets today are the longest in history.

INVESTMENT POSITION: Subscribers should be in short to medium-term money market instruments, and I don't care what it is as long as it's top quality and as long as it pays interest.

Sure you've missed some marvelous profits. At any time in history, no matter what the market is doing, you're going to miss "some marvelous profits." Get over it – it's the nature of the game.

Right now I'm watching to see whether the market is going to decline to test its September lows (8235 on the Dow). I was not satisfied with the September 21 market low – far too much bullishness, far too many people buying that low as if it was THE bear market bottom. It was notable that there was a total lack of any panic action at or near the lows.

If the market returns to test the September 21 low it will be a very important test. If the Dow breaks below 8235 I believe we could see some panic-type action, some real bearishness – and very possibly the formation of an important bottom. It won't be the ultimate bottom of this bear market, but it could be a tradeable bottom. If so, I will probably recommend some stocks to buy through my daily Web postings.

In the absence of a true "sold-out market low," I'd advise subscribers to stay in their protected positions in money market items or Treasury notes or high-grade muni bonds.

FIXED INCOME AND INTEREST RATES: This was on my recent web-site, but for those who receive only the Letter I want to repeat the following. In talking to my 23 year-old son, Ryan, about a certain preferred stock, I realized that he did not understand interest rates. And in talking to other subscribers, I have been surprised to learn how many subscribers shared Ryan's lack of understanding about rates.

So here goes. Let's take a preferred stock that pays a **fixed dividend** of $2.50 annually. Year in and year out that preferred stock will pay $2.50. But the price of the stock itself will fluctuate. One month the stock will sell for 35 dollars, a year later it will sell for 40, and five years later it will sell for 27 dollars. But the stock will always pay the same dividend amount of $2.50 a year.

Then why does the market price of this stock fluctuate? The price of this preferred stock fluctuates because it is influenced by prevailing **outside interest rates**.

One major factor in changing interest rates is inflation. Inflation is brought on by governments that create money. If too much money is created by the Federal Reserve, then those excess dollars drive up the price of goods. As the price of goods rises, it requires MORE DOLLARS to buy

the same items. This is price inflation. In price inflation it costs you $2.00 to buy a certain loaf of bread. Six months later it costs you $2.25 to buy that same loaf of bread.

Buyers of fixed income securities are not protected when inflation arrives. Unlike common stocks, which theoretically can raise their dividends during inflationary times, the preferred stock (discussed above) cannot raise its dividend. Thus, the price of that preferred stock, which pays a steady $2.50, will suffer during inflation.

The preferred stock will not be able to raise its dividend during inflation so how does it adjust? It adjusts by changing its price on the open market.

As inflation increases, the preferred stock will decline in price. It will decline because that fixed dividend of $2.50 is worth less and less in terms of purchasing power. Let's say the price of the stock is 35 on the open market. At that price the stock will yield 7.14% ($2.50 divided by 35). Next, inflation heats up and the price of the stock drops to 30. At 30, still with that same fixed $2.50 dividend the yield rises to 8.3% ($2.50 divided by 30). Thus the new buyer receives increased protection against inflation because he's getting a higher yield for his money.

But then a recession sets in and inflation drops to almost zero. That $2.50 dividend without inflation is worth a lot more. The stock rises in price to 40 dollars. At a price of 40 dollars, the same stock with the same $2.50 dividend drops in yield to 6.25% ($2.50 divided by 40).

So you see that we're dealing with a preferred stock that always pays the same $2.50 dividend but its price varies based on the state of inflation in the nation and thus the state of prevailing interest rates.

Question: How does the person who owns a slew of this preferred stock protect himself against inflation? **The only way is through compounding. He must continually reinvest that $2.50 dividend in more of the preferred stock.** This compounding process will probably outpace inflation over the years.

But he must continue to compound, or to reinvest. Otherwise, if inflation continues and the person spends the $2.50 dividend instead of reinvesting it, he's going to lose out since his original investment will be worth less and less as the years go by. His investments will be worth less and less because that fixed $2.50 dividend will buy him less and less in terms of goods and services.

By the way, I picked a preferred stock as an example in this piece. But you can substitute a bond for the preferred and the rationale remains the same.

For more on compounding, read "Rich Man, Poor Man" on my web-site.

NOTES & QUOTES: Is there manipulation in the stock market? You can bet there is. Some of it was documented in an article that appeared on the front page of the Oct. 18 *WSJ.* Right after the terrorist attacks on NYC and Washington, the Fed pumped $45 billion into the banking system. On top of that some securities firms "strongly discouraged their analysts from making negative stock calls." Other Wall Street firms "tried to keep a lid on short sales or bearish market bets." The Exchange itself tried to thwart people who wanted to protect themselves by selling their stocks. How did the Exchange do that? The Exchange itself closed down.

Finally, Wall Street and particularly its major houses followed a concerted effort of telling people not to panic, that everything would be all right, and that this was the worst time to sell stocks.

Did all the above help the situation? In my opinion, it did not. Anything that interferes with liquidity in the markets is, in my opinion, wrong and a mistake. If people want to panic the best thing to do is to let them panic. The market's later action will show whether they were right or wrong. In the end, the market will go where it wants to go anyway, with or without the panic. The best and the only thing the exchanges can do is to provide liquidity. All manipulation interferes with liquidity.

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The attack on NYC and Washington is considered by many to be "the worst disaster in US history." One thing is sure – insurance premiums are going to soar. That means a big increase in corporate expenses (and individual expenses too, if you live in a big city).

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The Bank of Japan's latest report has tossed aside its customary carefully shaded jargon and turned to blunt language. What they're saying – exports have been hit by the aftermath of the September 11 disaster in the US. Companies in Japan have handed out pink slips and have also trimmed wages.

This is the fifth consecutive month that the Bank has downgraded the outlook for the Japanese economy. Production has continued "to decline considerably," hurting employment and consumer confidence. "There exists a risk," writes the Bank, "that the prolonged downturn in US private consumption which is affected by the terrorist attacks would induce another round of adjustments in the Japanese economy, starting from the decline in exports such as consumer goods." Exports are critical in Japan because the strongest Japanese companies in an otherwise moribund economy rely heavily on sales in Europe and the US.

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Early in November the Concorde will return to the skies, both via Air France and the British Airways. The planes have been refurbished with new wiring, new fuel tanks, linings made of the same material as bullet-proof vests – and sturdier tires. And wait – there have been and maybe will again be discounts. The British Airways has been offering round-trip discounts of about 59%, meaning a round-trip from New York to London and back will be $4,999. I've made the trip on both Air France and British Airways. The flight itself is fabulous. NYC to Paris in three hours and twenty minutes. It's an experience you'll never forget. You'll be flying faster than the speed of sound.

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New York City has its Sullivan Law, which states that you are not allowed to even own a handgun. Not so here in the Wild West. In California between January 1st and October 11 here's how many handguns were sold – 109, 866. Is our murder rate any higher than New York City's? Nope.

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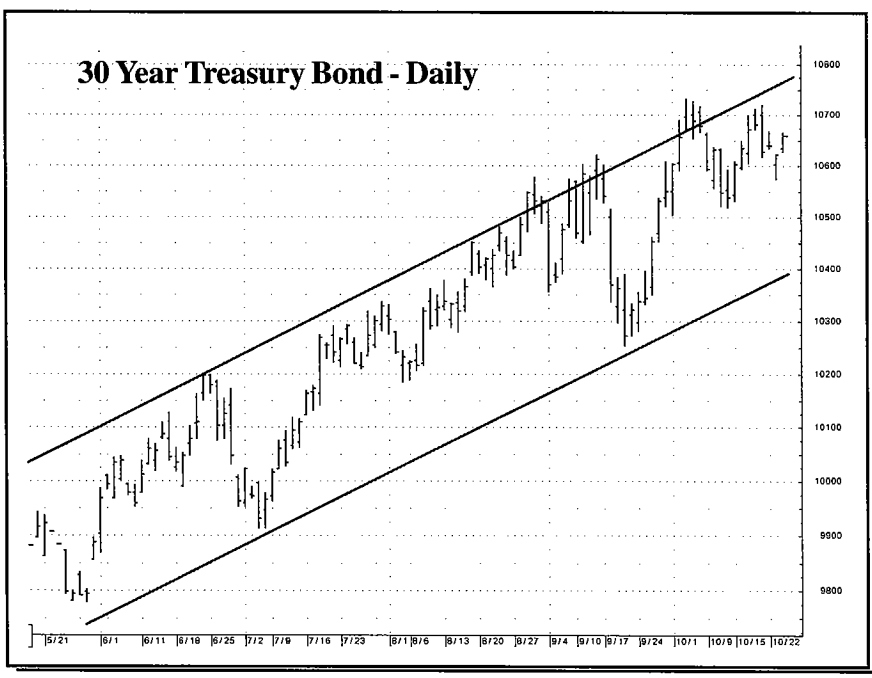
Those of us who have actually fought in wars know that it's always wise to know your enemy. An extraordinary column appeared in a recent *WSJ*, a column written by Fouad Ajami, who teaches at Johns Hopkins School of Advanced International Studies.

Here are a few excerpts: "Bin Laden and Zawahiri and Abu Gheith and Atta did not descend from the sky: They are the angry sons of failed Arab generations. They are direct heirs of two generations of Arabs that have seen all the high dreams of Asr al Hahda (the era of enlightenment and secular nationalism) issue in sterility, dictatorship and misery. The secular fathers begot this strange breed of holy warriors.

"A suffocating hate separates the ruler from the ruled in Arab lands. The former own those lands, they have closed up the universe, and their dominion stretches as far as the eye can see. Their scions stand ready to claim the good things of the earth. Imagine the way Arabs read the ascendancy of the sons of the dictators of Syria, Egypt, and Iraq in public life; a trick has been played on them. Under their eyes, the republics have been metamorphosed into monarchies in all but name. Alone, in God's broad lands, it seems to them, they have to be excluded from a share of today's democratic inheritance. The rulers can't deliver to us the sullen, resentful populations and – shrewd men – the rulers know it. They have ducked for cover as America blew in asking them to choose between the terrorists' world and ours."



Russell Comment: The stage is set for an ultimate revolt throughout the Arab world. At this point all their anger is directed against the US because it's "safer" than revolting against their own king-dictators. But it won't be long. Men with nothing to lose but their own lives are the most dangerous men in the world.

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A subscriber suggests that I list some of the record statistics and items that have been produced by this bear market. Big bull and big bear markets produce big statistics. Here are some that are worth listing.

CSCO – the greatest loss in market value for one stock in history.

Dow breaks below a preceding year's low for the first time in 18 years.

Dow breaks below the low of two preceding year's lows for the first time since 1975.

Manufacturing employment lowest since the early-1960s.

T-bill rates lowest since the early-1950s.

September 17 – industrial production down for 12 months in a row for the first time since 1940.

Week of September 17 – Dow falls 14.2 %, worst week since 1933.

Week of September 17 – highest volume ever.

Week of September 17 – Dow falls 684 points, worst ever in terms of points lost.

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Zimbabwe (formerly Rhodesia) is abandoning market-based economic policies and returning to a socialist-style economy. I was afraid of this when the blacks took over and it was announced that social justice had finally come to Rhodesia. Last week President Mugabe announced the new policy. He said that businesses which were opposed to the new regime should "pack up and go." Mugabe said a price freeze on basic foods imposed last Friday would be strictly enforced, and the government will seize any firm that shuts down, withholds their goods or engages in illegal profiteering. "Let no one on this front expect mercy," said Mugabe. "The state will take over any business that is closed."

The Zimbabwe economy has become crippled by inflation, unemployment and a shortage of hard currency. Analysts say the crisis worsened when the ruling-party militants began occupying white-owned commercial farms, which generate much of the currency in this agriculture-based state.

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Movie stars know what's going on. Buddhist actor Richard Gere told ABC Radio News that the best way to combat terrorism is to emit love vibes. "It's all of our jobs to keep our minds as expansive as possible," explained Richard."We have to give them medicine and the medicine is love and compassion. There's nothing better." Still, he added, the terrorists "are creating such horrible future lives for themselves because of the negativity of this karma."

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Can you believe it? Bill Clinton is quiet. He must be simmering with frustration because Bush, not he, has the chance to be "a great wartime president." Just as bad, the terrorist attacks and the "new war" is getting all the attention. For the first time in years, nobody seems to give a damn what Clinton is saying or doing.

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America may be in a nervous state, but our people are healthier than ever. Life expectancy is rising and is now at a record 76.9 years for Americans (actually 80 for white women). Heart disease is still the chief cause of death and cancer is second. Together they account for slightly more than half of the 2.4 million deaths in 2000. Stroke was the third most common death in 2000, followed by emphysema and lung diseases were fourth, accidents fifth and diabetes sixth. Influenza and pneumonia, seventh, Alzheimers eighth, kidney disease ninth, infections tenth, suicide eleventh, liver and cirrhosis twelfth, high blood pressure thirteenth and homicide last. As for the lowest death rate, Hawaii won the health prize with only 666.9 deaths per 100,000.

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NOTE: Many subscribers evidently don't realize that I write an extended piece on the market with closing figures every day except Sunday. But to avail yourself of this free addition and Internet access to Dow Theory Letters, you've got to have a computer.

If you haven't worked with a computer yet, I urge you to do so and get into the 21st century. Probably the easiest computer to work with is a Mac. My suggestion to you "computer hold-outs" is that you go to a computer store and ask one of those nice salesmen to show you how it works.

It's not that difficult. Let me put it this way – if I can learn to use a computer at my age, anybody can. Wife Faye calls me "hopeless" when it comes to mechanics. Yet I have learned to use a computer.

Next Mailing: November 21, 2001